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Online Sources of Finance: Supplementary Material

Chapter 6: Finance for entrepreneurship

1. Introduction

This supplementary material has been prepared for the online students' resources and to provide students with additional information on online sources of finance for entrepreneurship intended to supplement the relevant section in Chapter 6.

As discussed in Chapter 6, there has been a large growth in online sources of finance over the last decade, a growth which has accelerated in the last five years. This growth is a global phenomenon and has resulted in a growth in the number of platforms and in the volumes of business and finance raised. For example, a recent study was able to survey over 3,000 crowdfunding platforms across 161 countries worldwide (Raghavendra Rau, 2019). In the first five years of the past decade, the growth in volume of funding averaged 250% per annum.

Of course, online crowdfunding platforms do not necessarily provide sources of funding for entrepreneurs, some have been dedicated to raises funds for 'projects' and good causes (investors make donations). However, their growth has been such that, in some countries, they have become more important than traditional sources of funding for entrepreneurs, particularly private equity and venture capital sources, but also in providing accessible sources of business loans and debt finance for entrepreneurs. For example, in the UK in 2017, *Funding Circle*, an online crowdfunding platform providing small business loans, provided £114m of new lending to small businesses in the third quarter of the year, exceeding the £95m business lending of the UK's main commercial high street banks to equivalent small businesses (Arnold, 2017).

2. Factors accounting for the growth in 'online' crowdfunding platforms

There are a number of factors that have contributed to the growth of online sources of finance:

- Reduction of transaction costs and improving accessibility. Chapter 6 discusses some of the challenges that entrepreneurs face in raising sources of finance, both for sources of debt and equity finance. These challenges include providing financial track records (for new businesses), search procedures and costs such as agency fees. Online crowdfunding sites provide accessibility and may reduce costs in preparing applications. These are demand-side issues for entrepreneurs.
- For providers, online platforms have advantages of sharing risks, through the principles of crowdfunding, and make relatively small amounts of funding, such as micro-loans or small amounts of equity, relatively viable. These are supply-side issues for providers.
- Online platforms eliminate the search procedure that is necessary for entrepreneurs to raise private equity and business angel since investors can more easily find entrepreneurial ventures that 'match' their requirements.
- Online platforms offer viable sources for entrepreneurs in 'high risk' tech sectors and new venture businesses where the risks are greater and may require specialised sources of venture finance.
- Online platforms are available globally, irrespective of in which country they are based.

3. Costs and disadvantages of online sources

Although crowdfunding platforms offer significant benefits that have accounted partly for their growth, there are disadvantages which may include the following issues, these lie in two main areas:

- For sources of equity, there is likely to be no value-added from raising venture funding since the many small equity holders that will be involved will not be directly involved in adding value as would be the case when raising finance from a business angel or from a network of business angels. However, there may still be relationships established between investors and entrepreneurs that have received their equity-based funding.
- For sources of debt finance, there will be no access to a banking relationship manager who can offer advice, follow-on funding and assistance with the growth of the entrepreneur's business.

4. Performance of entrepreneurs with online sources of finance

Not surprisingly, where studies have been undertaken on the subsequent performance of entrepreneurs and small businesses that have raised finance through crowdfunding platforms, compared to those from the more traditional sources of finance, they have shown that such businesses have performed less successfully (Walthoff-Borm, 2018).

5. Some further examples of crowdfunding online platforms supplementing those indicated in Chapter 6

The best known examples are in the US, such as the Kickstater platform (http://www.kickstarter.com). Kickstarter is a funding platform for creative projects, including films, games, design, theatre productions, publications and new technology. Individuals with new projects apply to Kicksarter to host their ideas, which may be illustrated with videos, written descriptions and pictorial representations. They then effectively 'appeal' for funding using the platform that operates an 'all or nothing policy'. That is, if an individual project does not reach its funding goal, zero funds will be committed to it and the project is withdrawn.

There are European examples of funding platforms that are using similar principles of online platforms that host new business ideas from nascent and existing entrepreneurs who are seeking funding. By signing up to such platforms, individual investors can commit small amounts of funding, effectively spreading their risks between a number of projects. The platform replaces the role and function of intermediaries by undertaking a risk assessment, vetting and placing projects in risk 'categories'. An example is the Funding Circle platform in the UK (http://www.fundingcircle.com). This is an online market place that claims to offer lower costs loans for businesses and higher returns for investors. This is sometimes described as a peer-to-peer platform (P2P) since it provides a platform for a direct investor-entrepreneur relationship.

Other examples of P2P platforms include the German social lending platform Smava (http://www.smva.de) and in the private lending platform Zopa (http://www.zopa.com). Smava claims to have doubled its loan volume from €2.5m in the second quarter of 2009 to €5m in the third and is reported as being more successful than an equivalent platform in the US, Prosper (http://www.prosper.com).

Crowdcube (http://www.crowdcube.com)

A UK-based platform that uses a direct ownership structure for the equity deals that are agreed and secured.

Seedrs: (http://www.seedrs.com)

A UK-based platform that, in contrast to Crowdcube, uses a nominee structure for the equity deals.

6. Conclusion

Crowdsourcing is now an established phenomenon that has become an alternative platform for entrepreneurs and small businesses to access funding via an online platform. They provide a means for entrepreneurs to overcome some of the challenges that they face from smallness, novelty and risk in seeking to source and raise finance as a resource. The factors discussed earlier and the ability to overcome barriers has led to their remarkable growth globally. However, it should be remembered that the issues discussed in Chapter 6, such as adverse selection, risk assessment and even search procedures still apply to their provision and use.

References

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